DIRECT TESTIMONY AND EXHIBITS OF

MATTHEW P. SCHELLINGER II

ON BEHALF OF

THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF

DOCKET NO. 2018-82-S

IN RE: APPLICATION OF PALMETTO WASTEWATER RECLAMATION, LLC

FOR ADJUSTMENT OF RATES AND CHARGES

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.

A. My name is Matthew P. Schellinger II. My business address is 1401 Main Street, Suite 900, Columbia, South Carolina, 29201. I am employed by the Office of Regulatory Staff ("ORS") in the Utility Rates and Services Division as a Regulatory Analyst.

Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. I received a Bachelor of Science Degree with a major in Accounting from the University of South Florida in 2012. I received a Master of Business Administration with a focus in Management and Strategy from Western Governors University in 2016. From 2007 to 2013, I was employed as a controller for an insurance agency. In that capacity, I performed general corporate accounting functions on a daily and monthly basis. In February 2013, I began my employment with ORS as an Auditor. In May 2016, I joined the Utility Rates and Services Division as a Regulatory Analyst.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA ("COMMISSION")?

A. Yes. I have testified before the Commission in connection with hearings concerning the Fuel Adjustment Clause, general rate cases, natural gas, and water and wastewater matters.

Q. WHAT IS THE MISSION OF THE OFFICE OF REGULATORY STAFF?

A. ORS represents the public interest as defined by the South Carolina General Assembly as:

> The concerns of the using and consuming public with respect to public utility services, regardless of the class of customer, and preservation of continued investment in and maintenance of utility facilities so as to provide reliable and high-quality utility services.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony is to set forth ORS's findings relative to my review of the rate increase application ("Application") submitted by Palmetto Wastewater Reclamation, LLC ("PWR" or "Company"). Specifically, I will focus on the ORS recommendations in the following areas:

- Excess Deferred Income Taxes ("EDIT") in rate base;
- Amortization of EDIT; and,
- Excess revenues collected by PWR since January 1, 2018.

Q. PLEASE EXPLAIN THE TAX CUTS AND JOBS ACT ("TCJA").

A. On December 22, 2017, the Tax Cuts and Jobs Act was signed into law. The TCJA contains provisions including, but not limited to, decreasing the corporate tax rate from 35% to 21%, effective January 1, 2018. Many South Carolina utilities under the jurisdiction of this Commission recover federal corporate income tax expenses at a corporate tax rate above 21% because federal income tax is a component of rates approved by the Commission.

On April 25, 2018, the Commission issued Order No. 2017-308 in Docket No. 2017-381-A which required all utilities to calculate and defer in a regulatory liability account the tax effects resulting from the TCJA beginning January 1, 2018 with those impacts to be addressed in the next general rate case.

Q. WHAT ARE THE IMPACTS OF THE TCJA ON PWR AND ITS CUSTOMERS?

A. The impacts of the TCJA are reflected in the following areas:

- A reduction in the federal corporate income tax rate from 34%[1] to 21%;
- A re-valuation of Accumulated Deferred Income Taxes ("ADIT") to incorporate the reduction in the federal income tax rate;
- Creation and amortization of EDIT; and,
- Excess revenues collected after January 1, 2018.

For a more thorough description on the treatment of income tax rate changes please see Exhibit MPS-5.

Q. PLEASE DESCRIBE THE IMPACT TO THE CUSTOMERS DUE TO THE REDUCTION OF THE CORPORATE INCOME TAX RATE.

A. The TCJA reduced the current federal income tax expense for PWR from 34% to 21%. This resulted in savings of approximately $56,387 to customers in this rate proceeding.[2]

Q. WHAT IS ACCUMULATED DEFERRED INCOME TAX AND WHY IS IT IMPORTANT?

[1] Commission Order No. 2014-752 approved a rate structure that provided PWR recovery of federal income tax expenses at 34%.
[2] Based on ORS adjustments.

A. Many timing differences exist between when income taxes are collected from customers in rates and when the Company pays those taxes to the United States Internal Revenue Service ("IRS"). Sometimes the taxes are paid before they are collected from customers (creating a deferred tax asset), and sometimes they are paid after (creating a deferred tax liability). Deferred tax balances result from book/tax timing differences between recognition of income and expenses. Deferred tax balances are included in rate base as they are a cost free source of capital provided by the customers. Assuming all things, including the tax law, remain constant, deferred tax balances, whether assets or liabilities, reverse over time and converge to zero over the life of the underlying item giving rise to the deferred tax balance.

However, as explained in greater detail below, if the tax rate changes, the potential arises whereby the deferred tax balance would not naturally converge to zero over the life of the underlying item giving rise to the tax balance.

Q. PLEASE EXPLAIN WHY THE TCJA REQUIRES ACCUMULATED DEFERRED INCOME TAX TO BE REVALUED.

A. When the tax rate is lowered, a portion of ADIT will never be paid to the IRS, which creates "excess deferred income taxes." EDIT indicates the Company charged and collected from its customers higher taxes in earlier years than the taxes the Company will pay in the future. The TCJA's reduction in federal income tax rates create an obligation to return to customers the excess tax collected and reflected in EDIT.

Q. PLEASE DESCRIBE THE DIFFERENT CLASSIFICATIONS OF EDIT.

A. EDIT is derived from different categories of timing differences, and those categories have differing treatment by the TCJA. Below, I discuss the treatment of protected and unprotected EDIT separately.

Protected EDIT

The TCJA requires excess deferred taxes generally associated with property, and specifically connected to the accelerated depreciation of property, to be returned to customers in a manner that mimics the remaining life of the underlying assets that generated the ADIT. This is classified as "protected" EDIT. The IRS requires the Company to return the protected EDIT in a prescribed manner. To do otherwise, could trigger a tax normalization violation causing the Company to lose its ability to accelerate depreciation. The normalization rules require protected EDIT to be flowed back over the remaining lives of the property giving rise to the deferred tax balance.

Unprotected EDIT

The remaining EDIT or "unprotected" EDIT may be treated by the Commission like any other regulatory liability in the rate-setting process. In other words, the Commission retains the discretion to determine the time period over which the unprotected EDIT is returned to customers. Most Commissions select a shorter time period for amortization of unprotected EDIT due to the underlying timing differences reversing over a shorter period of time.

Q. DID PWR PROPOSE TO REVALUE AND RETURN EDIT TO ITS CUSTOMERS?

A. No. In the Application, PWR calculated ADIT using a 21% income tax rate and omitted any calculation of EDIT related to the TCJA. PWR has not proposed a reduction to rate base associated with EDIT. PWR has not proposed an amortization, or return, of the

EDIT to its customers for either the protected or unprotected categories as required by the IRS (*See* Exhibit MPS-4).

Q. PLEASE DESCRIBE ORS'S POSITION ON THE IMPACT OF EDIT TO PWR'S RATE BASE.

A. The creation of the EDIT regulatory liability is offset by the reduction to ADIT, which neutralizes the impact to PWR's rate base. ORS determined the appropriate amount for the EDIT liability, with ORS adjustments, is $456,531 (Exhibit MPS-1). ORS requested from the Company through discovery a calculation of the EDIT. The summary page of the response to Utility Rates Request #9 is provided in Exhibit MPS-3. ORS included one year's worth of amortization of EDIT in the calculation of PWR's rate base. ORS's recommendation is reflected in ORS witness Seale's Exhibit CLS-2.

Q. PLEASE DESCRIBE ORS'S POSITION ON THE AMORTIZATION, OR RETURN, OF EDIT TO PWR'S CUSTOMERS.

A. ORS requested through discovery a calculation of the EDIT from the Company. A summary was provided to ORS (*See* Exhibit MPS-3) and ORS agrees the return periods provided by PWR are appropriate for protected EDIT and unprotected EDIT. ORS calculated the first year amortization of EDIT of $10,272 (*See* Exhibit MPS-1), which should be grossed up for taxes for a total of $13,662. This is shown in ORS witness Seale's Exhibit CLS-2.

Q. ARE THERE OTHER IMPACTS OF THE TCJA?

A. Yes. The reduction in the federal income tax rate to 21% resulted in an accumulation of Excess Revenues collected by PWR. The Excess Revenue balance was created due to PWR billing rates to customers that included recovery of the federal income tax rate of 34%. The Excess Revenue generated after December 31, 2017, should be returned to PWR's customers because the Company is not required to pay a federal income tax rate higher than 21%.

Q. DID PWR INCLUDE THE RETURN OF EXCESS REVENUES IN ITS APPLICATION OR DIRECT TESTIMONY?

A. No. PWR did not provide a calculation of the Excess Revenues or the Commission required regulatory liability account in its Application or through direct testimony. Nor did PWR propose to return any Excess Revenues the Company has collected since January 1, 2018.

Q. PLEASE DESCRIBE THE EXCESS REVENUES DEFERRAL PROPOSED BY ORS.

A. In compliance with Commission Order No. 2018-308, ORS calculated the deferred impacts of the TCJA and placed that amount into a regulatory liability. The deferral includes the difference between customer revenues actually billed and what would have been billed taking into effect the reduced corporate tax rate beginning January 1, 2018. ORS utilized the Commission-approved cost of service[3] to determine the excess revenues imbedded in PWR's approved rates. In the ORS calculation of the regulatory liability, ORS estimated new rates to be effective no later than May 5, 2019. The total Excess Revenues regulatory liability is $231,707, the calculations for which are provided in Exhibit MPS-2.

Q. WHAT TIME PERIOD DOES ORS RECOMMEND FOR THE RETURN OF EXCESS REVENUES TO PWR CUSTOMERS?

[3] Docket No. 2014-69-S, Order No. 2014-752

A. ORS recommends the Excess Revenues collected by PWR be returned to customers over three (3) years through a reduction in the Company's revenue requirement. A three (3) year return period balances the benefits to the customer and Company equitably. This amortization is $77,236 annually and is reflected in ORS witness Seale's Exhibit CLS-2.

Q. PLEASE SUMMARIZE OTHER DOCKETS IN WHICH THE COMMISSION HAS OR WILL ADDRESS THE IMPACTS OF THE TCJA.

A. In Docket No. 2017-292-WS,[4] the Commission ruled that the EDIT calculation for Carolina Water Service, Inc. ("CWS") was rate base neutral as it was being returned to customers. Further, the Commission determined that the amortization of EDIT was a reduction to CWS's cost of service for purposes of determining a revenue requirement.

In Docket No. 2017-370-E, the Commission ruled that EDIT for South Carolina Electric & Gas Company ("SCE&G") should be amortized and returned to customers through a Tax Savings Rider. Further, the Commission determined that there were current tax savings that resulted in excess revenue collections that should be returned to customers through the Tax Savings Rider.

In Docket No. 2018-257-WS, ORS and Kiawah Island Utility, Inc. ("Kiawah") agreed to tax treatment for the recalculation of EDIT as rate base neutral, the return of EDIT to customers as reductions to the revenue requirement, and the return of excess revenues collected since January 1, 2018.

In Docket No. 2018-319-E, ORS and Duke Energy Carolinas, LLC agree to similar tax treatment for the recalculation of EDIT as rate base neutral, the return of EDIT to customers, and the return of excess revenues collected since January 1, 2018.

[4] Order No. 2018-345(A)

In Docket No. 2018-318-E, ORS and Duke Energy Progress, LLC agree to similar tax treatment for both the recalculation of EDIT as rate base neutral, the return of EDIT to customers, and the return of excess revenues collected since January 1, 2018.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.

Exhibit MPS-1

Office of Regulatory Staff
Excess Deferred Income Taxes
Palmetto Wastewater Reclamation, LLC
Docket No. 2018-82-S

Category		Starting Balance EDIT [1]	Proposed Return Period (yrs) [1]	1/1/2018 Balance	2018 Amortization	1/1/2019 Balance	2019 Amortization	EDIT to Rate Base
Fixed Assets [2]	$	483,925	per schedule	483,925	4,199	479,726	10,092	469,634
Intangibles [3]		23,940	4	23,940	5,985	17,955	5,985	11,970
Allow. for Doubtful Accts. [3]		(9,431)	2	(9,431)	(4,715)	(4,716)	(4,715)	(1)
AFUDC [3]		(27,252)	25	(27,252)	(1,090)	(26,162)	(1,090)	(25,072)
Total		**471,182**		**471,182**	**4,379**	**466,803**	**10,272**	**456,531**

Annual Amortization, Grossed up for Taxes	**13,662**	to Exhibit CLS-2
Reduction to Rate Base for EDIT	**(456,531)**	to Exhibit CLS-2

Notes:

(1) - Source - Utility Rates Request #9 - Provided on 02/01/2019

(2) - Protected Excess Deferred Income Taxes - Return per ARAM or RSGM

(3) - Unprotected Excess Deferred Income Taxes - Return per Commission Discretion

Office of Regulatory Staff
Excess Revenue Liability
Palmetto Wastewater Reclamation, LLC
Docket No. 2018-82-S

Line No.	Item	Palmetto Wastewater Reclamation, LLC Docket No. 2014-69-S: 34% Federal Income Tax Rate	Palmetto Wastewater Reclamation, LLC Docket No. 2014-69-S: 21% Federal Income Tax Rate	
1	Operating revenues	3,650,539	3,650,539	
2	Operating expenses	1,710,413	1,710,413	
3	Depreciation/Amortization	446,424	446,424	
4	Taxes other than Income	280,176	280,176	
5	Interest expense	219,597	219,597	
6	Taxable income (L1 - (Sum (L2 thru L4))	993,929	993,929	
7	State income tax (L5 * 5.0% tax rate)	49,696	49,696	
8	Federal income tax ((L5-L6) * tax rate)	321,039	198,289	
9	Net income (L5 - L6 - L7)	623,193	745,944	
10	Cumulative change in net income for return		122,750	
11	Retention factor		75.05%	
12	Annual Revenue impact of cumulative change		163,558	
13	**Regulatory Liability Calculation (1/1/18-5/30/19)**		**$ 231,707**	
14	Amortization life for Regulatory Liability		3	
15	Annual Amortization		**$ 77,236**	to Exhibit CLS-2

Office of Regulatory Staff
Utility Rates Request #9 - Summary - Calcs
Palmetto Wastewater Reclamation, LLC
Docket No. 2018-82-S

PWR -- Regulatory Liability (Deferral) Account due to TCJA

Effect Schedule

Summary	Total	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	2039
Effect due to Change in ADIT	$ 471,182	$ 4,379	$ 10,272	$ 14,920	$ 14,861	$ 8,714	$ 14,111	$ 19,479	$ 19,405	$ 18,028	$ 17,205	$ 13,685	$ 15,006	$ 18,216	$ 19,295	$ 9,174	$ 3,024	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)
Effect due to Income Tax Change Retroactve to 1/1/18 (12 months)	71,708	14,342	14,342	14,342	14,342	14,342																
Total Regulatory Liability (Deferral) Account -- TCJA	542,890	$ 18,720	$ 24,613	$ 29,261	$ 29,202	$ 23,055	$ 14,111	$ 19,479	$ 19,405	$ 18,028	$ 17,205	$ 13,685	$ 15,006	$ 18,216	$ 19,295	$ 9,174	$ 3,024	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)

Effects of Change in ADIT

Category	Starting Balance	Proposed Return Period (yrs)	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	2039
Fixed Assets	$ 483,925	per schedule	$ 4,199	$ 10,092	$ 10,025	$ 9,966	$ 9,804	$ 15,201	$ 20,570	$ 20,495	$ 19,118	$ 18,295	$ 14,775	$ 16,096	$ 19,307	$ 20,385	$ 10,264	$ 4,115	$ -	$ -	$ -	$ -	$ -
Intangibles	23,940	4	5,985	5,985	5,985	5,985																	
Allow. for Doubtful Accts.	(9,431)	2	(4,715)	(4,715)																			
AFUDC	(27,252)	25	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)	(1,090)
Total	**471,182**																						
Effect due to Change in ADIT			**$ 4,379**	**$ 10,272**	**$ 14,920**	**$ 14,861**	**$ 8,714**	**$ 14,111**	**$ 19,479**	**$ 19,405**	**$ 18,028**	**$ 17,205**	**$ 13,685**	**$ 15,006**	**$ 18,216**	**$ 19,295**	**$ 9,174**	**$ 3,024**	**$ (1,090)**	**$ (1,090)**	**$ (1,090)**	**$ (1,090)**	**$ (1,090)**

Development of Plant Related Deferred Taxes
Dollars

	Total
Basis for Deferred Taxes	
Alpine	$ (4,214,687)
Woodland	296,264
Total	(3,918,424)
Deferred Taxes	
@ 37.3%	
Alpine	(1,572,078)
Woodland	110,506
Total	(1,461,572)
@ 24.95%	
Alpine	(1,051,564)
Woodland	73,918
Total	(977,647)
Difference	
Alpine	520,514
Woodland	(36,589)
Total	483,925

*Not actually booked as of 12-31-18.

	Balance at 12/31/18
Intangibles	
Basis for Deferred Tax	193,848
Deferred Tax at 37.3%	72,305
Deferred Tax at 24.95%	48,365
Difference	$ 23,940
Allowance for Doubtful Accts.	
Basis for Deferred Tax	76,361
Deferred Tax at 37.3%	28,483
Deferred Tax at 24.95%	19,052
Difference	$ (9,431)
AFUDC	
Basis for Deferred Tax	220,668
Deferred Tax at 37.3%	82,309
Deferred Tax at 24.95%	55,057
Difference	$ (27,252)

Office of Regulatory Staff
Utility Rates Request #9 - Summary - Calcs
Palmetto Wastewater Reclamation, LLC
Docket No. 2018-82-S

2040	2041	2042	2043	2044	2045	2046	2047	2048	2049	2050	2051	2052	2053	2054	2055	2056	2057	2058	2059	2060	2061	2062	2063	2064	2065
$ (1,090)	$ 1,676	$ 6,786	$ 9,838	$ 14,071	$ 16,925	$ 16,574	$ 15,595	$ 15,541	$ 15,403	$ 15,329	$ 15,036	$ 14,128	$ 13,586	$ 13,564	$ 13,504	$ 13,314	$ 11,636	$ 9,708	$ 9,104	$ 7,292	$ 4,744	$ 3,459	$ 1,077	$ 25	$ 33
$ (1,090)	$ 1,676	$ 6,786	$ 9,838	$ 14,071	$ 16,925	$ 16,574	$ 15,595	$ 15,541	$ 15,403	$ 15,329	$ 15,036	$ 14,128	$ 13,586	$ 13,564	$ 13,504	$ 13,314	$ 11,636	$ 9,708	$ 9,104	$ 7,292	$ 4,744	$ 3,459	$ 1,077	$ 25	$ 33

2040	2041	2042	2043	2044	2045	2046	2047	2048	2049	2050	2051	2052	2053	2054	2055	2056	2057	2058	2059	2060	2061	2062	2063	2064	2065
$ -	$ 2,766	$ 7,876	$ 10,928	$ 14,071	$ 16,925	$ 16,574	$ 15,595	$ 15,541	$ 15,403	$ 15,329	$ 15,036	$ 14,128	$ 13,586	$ 13,564	$ 13,504	$ 13,314	$ 11,636	$ 9,708	$ 9,104	$ 7,292	$ 4,744	$ 3,459	$ 1,077	$ 25	$ 33
(1,090)	(1,090)	(1,090)	(1,090)																						
$ (1,090)	**$ 1,676**	**$ 6,786**	**$ 9,838**	**$ 14,071**	**$ 16,925**	**$ 16,574**	**$ 15,595**	**$ 15,541**	**$ 15,403**	**$ 15,329**	**$ 15,036**	**$ 14,128**	**$ 13,586**	**$ 13,564**	**$ 13,504**	**$ 13,314**	**$ 11,636**	**$ 9,708**	**$ 9,104**	**$ 7,292**	**$ 4,744**	**$ 3,459**	**$ 1,077**	**$ 25**	**$ 33**

Exhibit MPS-4

PUBLIC LAW 115–97—DEC. 22, 2017[1]

(d) NORMALIZATION REQUIREMENTS.—

(1) IN GENERAL.—A normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of section 167 or 168 of the Internal Revenue Code of 1986 if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method.

(2) ALTERNATIVE METHOD FOR CERTAIN TAXPAYERS.—If, as of the first day of the taxable year that includes the date of enactment of this Act—

(A) the taxpayer was required by a regulatory agency to compute depreciation for public utility property on the basis of an average life or composite rate method, and

(B) the taxpayer's books and underlying records did not contain the vintage account data necessary to apply the average rate assumption method, the taxpayer will be treated as using a normalization method of accounting if, with respect to such jurisdiction, the taxpayer uses the alternative method for public utility property that is subject to the regulatory authority of that jurisdiction.

(3) DEFINITIONS.—For purposes of this subsection—

(A) EXCESS TAX RESERVE.—The term ''excess tax reserve'' means the excess of—

(i) the reserve for deferred taxes (as described in section 168(i)(9)(A)(ii) of the Internal Revenue Code of 1986) as of the day before the corporate rate reductions provided in the amendments made by this section take effect, over

(ii) the amount which would be the balance in such reserve if the amount of such reserve were determined by assuming that the corporate rate reductions provided in this Act were in effect for all prior periods.

(B) AVERAGE RATE ASSUMPTION METHOD.—The average rate assumption method is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes. Under such method, during the time period in which the timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying—

(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by

(ii) the amount of the timing differences which reverse during such period.

(C) ALTERNATIVE METHOD.—The ''alternative method'' is the method in which the taxpayer—

(i) computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and

(ii) reduces the excess tax reserve ratably over the remaining regulatory life of the property.

(4) TAX INCREASED FOR NORMALIZATION VIOLATION.—If, for any taxable year ending after the date of the enactment of this Act, the taxpayer does not use a normalization method of accounting for the corporate rate reductions provided in the amendments made by this section—

(A) the taxpayer's tax for the taxable year shall be increased by the amount by which it reduces its excess tax reserve more rapidly than permitted under a normalization method of accounting, and

(B) such taxpayer shall not be treated as using a normalization method of accounting for purposes of subsections (f)(2) and (i)(9)(C) of section 168 of the Internal Revenue Code of 1986.

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[1] Source: https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf

ACCOUNTING FOR PUBLIC UTILITIES

Volume 1

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2018

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LexisNexis

§ 17.06 Income Tax Rate Issues

This section provides a general discussion of the treatment of income tax rate changes and reviews the effect Alternative Minimum Tax has in the determination of consolidated income tax expense for public utilities.

[1] Treatment of Income Tax Rate Changes

One of the major controversies concerning the use of the normalization method of accounting was the proper method for accounting for changes in the federal statutory

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[65] See, e.g., Ltr Ruls 8801041, 8711050, 8643052, 8525156.

[66] See Notice 89-63, 1989-1 CB 720. In connection with the regulation project, the Service also revoked Ltr Rul 8711050 via Ltr Rul 8935009, and Ltr Rul 8643052 via Ltr Rul 8935010.

income tax rate. This section briefly discusses the ultimate resolution with the passage of the TRA of 1986.

[a] The Tax Reform Act of 1986

The TRA 1986[67] reduced the corporate federal statutory income tax rate from 46 percent to 34 percent effective July 1, 1987. However, in light of the controversy sparked by the previous corporate tax rate reduction, Congress recognized the need to enact definitive guidelines for public utilities using the normalization method of accounting. Accordingly, the TRA 1986 specifically provided for the normalization of the excess deferred tax reserves resulting from the reduction of the corporate federal statutory income tax rate.[68] The TRA 1986 provided that if the excess deferred taxes are reduced more rapidly or to a greater extent than the reserve would be reduced under the Average Rate Assumption Method (ARAM), the taxpayer would not be considered to be using a normalization method of accounting with respect to any of its assets.[69]

[b] The Tax Cuts and Jobs Act of 2017

The Tax Cuts and Jobs Act of 2017 (TCJA) was signed into law on December 22, 2017. The Act reduced the corporate federal statutory income tax rate from 35 percent to 21 percent effective January 1, 2018. Like the TRA 1986, the TCJA specifically provided for normalization of the excess deferred tax reserves resulting from the reduction of the corporate federal statutory income tax rate. The TCJA also provided that if the excess deferred taxes are reduced more rapidly or to a greater extent than the reserve would be reduced under ARAM (see below), the taxpayer would not be considered to be using a normalization method of accounting with respect to any of its assets.

[c] The Average Rate Assumption Method

Under a normalization method of accounting, additions to the utility's deferred tax liabilities are made in the early years of an asset's life in order to reflect the deferral of taxes resulting from the difference between the amount of accelerated depreciation used for tax purposes and the amount of straight-line depreciation used for book purposes. According to the ARAM, to determine the amount of deferred taxes that must be added to the utility's deferred tax liabilities, the difference between the two amounts is multiplied by the federal statutory income tax rate in effect at the time of deferral.

Downward adjustments to the utility's deferred tax liabilities are made in later years of an asset's life, when the amount of straight-line depreciation used for book purposes exceeds the amount of depreciation taken for tax purposes. Because the TCJA reduced the corporate tax rate from 35 percent to 21 percent, the public utilities that had been

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[67] Pub L No 99-514, 99th Cong. 2d Sess (Oct 22, 1986) at § 601(a), effective for tax years beginning after July 1, 1987 (§ 601(b)).

[68] *Id* at § 203(e).

[69] See S Rep No 313, 99th Cong, 2d Sess 98 (1986).

making additions to their liabilities for deferred taxes based on the 35-percent tax rate have an excess in their liabilities for deferred taxes. The reason for this excess is that federal income tax deferrals that had been computed based on a tax rate of 35 percent are being "reversed" out when the tax rate is only 21 percent. The ARAM for calculating the reversal of deferred taxes ensures the normalization of this excess in the utility's liabilities for deferred taxes.

The following basic example is designed to illustrate how the ARAM works. It ignores tax and book basis differences in assets, salvage values, and depreciation conventions.

Example: A piece of equipment costing $1,000 was placed in service in 1985 when the corporate tax rate was 46 percent. For tax purposes, the equipment is classified as five-year ACRS property. For book purposes, the utility uses the straight-line method over a ten-year useful life. In 1987, the utility is subject to a blended corporate tax rate of 40 percent, and in 1988 and subsequent years the applicable corporate rate is 34 percent. The following table illustrates the normalization of the utility's excess deferred taxes using ARAM.

Basic Illustration of Average Rate Assumption Method

	Depreciation					Deferred Tax	
Year	Tax	Book	Annual Difference	Cumulative Difference	Tax Rate	Expense	Reserve Balance
1985	150	100	50	50	46%	23	23
1986	220	100	120	170	46%	54	77
1987	210	100	110	280	40%	44	121
1988	210	100	110	390	34%	37	158
1989	210	100	110	500	34%	37	195
1990	0	100	(100)	400	39%*	(39)	156
1991	0	100	(100)	300	39%	(39)	117
1992	0	100	(100)	200	39%	(39)	78
1993	0	100	(100)	100	39%	(39)	39
1994	0	100	(100)	0	39%	(39)	0
	1,000	1,000	0			0	

* Deferred tax reserve balance of 195 divided by the associated cumulative difference of 500.

As shown in the table above, additions to the utility's deferred tax liabilities in years 1985 through 1989 were computed based on the effective tax rates for those years (i.e., 46 percent in 1985 and 1986, 40 percent in 1987, and 34 percent in 1988 and 1989). The reversals from the utility's deferred tax liabilities in years 1990 through 1994 are computed using the weighted average of the effective tax rates for years 1985 through 1989.[70] At the end of 1994, the utility's deferred tax liabilities have been reduced to zero, and there is no remaining balance.

[70] The weighted average rate is an historical composite tax rate used to provide deferred federal income tax. It is the ratio of the cumulative deferred taxes (i.e., the balance in the deferred tax reserve immediately before the turnaround period) over the total remaining timing differences for which the deferred taxes were provided.

[d] Reverse South Georgia Method

A utility's property records might not contain the vintage account data that is necessary to apply the ARAM. In this situation, utilities are permitted to use an alternative normalization accounting method, known as the "Reverse South Georgia" method, to reduce their reserves for deferred taxes.[71]

The Reverse South Georgia method is a variation of the South Georgia method. (The South Georgia method is discussed in § 17.01[5], above.) Under the Reverse South Georgia method, the excess tax reserve on all public utility property in the plant account is computed based on the weighted average life or composite rate used to calculate depreciation for regulatory purposes. The excess tax reserve so computed is then reduced ratably over the regulatory life of the property.

Because the Reverse South Georgia method frequently results in reductions to a utility's deferred tax reserve sooner and to a greater extent than would be the case under the ARAM, the use of the Reverse South Georgia method represents a departure from the strict normalization requirements of TRA 1986. Therefore, the Reverse South Georgia method may be used by a utility only if the following two conditions are met:

(1) The utility is required by its regulatory commission to use an average life or composite rate method in computing depreciation expense for regulatory purposes; and

(2) The utility's books and underlying property records do not contain the vintage account data necessary to apply the ARAM.

If a utility's books and underlying property records do contain sufficient vintage year data to apply the ARAM, the use of the Reverse South Georgia method by the utility constitutes a normalization violation.

[71] See Rev Proc 88-12, 1988-1 CB 637; Ltr Ruls 8910012, 8825032, 8825033, and 8825035.

[72] See IRC § 56 (1954).

[73] See IRC § 57 (1954).

[74] Pub L No 99-514, 99th Cong, 2d Sess (Oct 22, 1986) at § 701, codified at IRC §§ 53–59 (1986).